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IN THE

# Supreme Court of the United States

October Term, 1995

UNITED STATES OF AMERICA,

*Petitioner,*

v.

WINSTAR CORPORATION, *et al.*,

*Respondents.*

On Writ of Certiorari to the
United States Court of Appeals
For the Federal Circuit

## BRIEF *AMICUS CURIAE* OF KEYSTONE HOLDINGS, INC., AND AMERICAN SAVINGS BANK, F.A. IN SUPPORT OF RESPONDENTS

Filed by Consent of the Parties

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## STATEMENT OF AMICI'S INTEREST

The amici are an investor group consisting of Keystone Holdings, Inc. ("Keystone") and American Savings Bank, F.A. of Stockton, California ("New American"). In late 1988, pursuant to a comprehensive written contract with the Federal Savings and Loan Insurance Corporation ("FSLIC") and the Federal Home Loan Bank Board ("FHLBB"), Keystone and New American assumed more than $30 billion of liabilities owed to depositors and others and acquired certain of the assets of a failed predecessor thrift ("Old American") from FSLIC and FHLBB.

At the time of the transaction, Old American was the largest insolvent thrift and the second largest thrift of any kind in the country. It had barely survived one of the largest bank runs in U.S. financial history. Its liabilities, substantially all of which FSLIC insured, vastly exceeded its assets.

As part of the transaction, amici: (1) paid $350 million cash as FSLIC directed, and agreed to make further payments of up to $450 million; (2) gave FSLIC a warrant representing 30 percent of the sales value of the reorganized thrift; (3) assumed billions of dollars of FSLIC liabilities to depositors; (4) undertook to manage more billions of dollars of severely troubled real estate assets for the benefit of FSLIC; and (5) despite FSLIC's insolvency, extended $8 billion in credit to FSLIC in return for a ten-year note.[1]

In the transaction, amici neither acquired nor created any "goodwill" or any other intangible asset. But the terms and conditions of the $8 billion FSLIC note illuminate the real commercial substance of the capital agreements regarding "goodwill" and "capital credits" that the government challenges before this Court.

Amici accepted the $8 billion note from FSLIC with the clear written commitment from FSLIC and FHLBB that the note would bear interest at a rate 200 basis points in excess of

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[1] *See* RTC, *Report to the Oversight Board of the RTC and the Congress on the 1988/89 FSLIC Assistance Agreements*, Vol. 6, Tab 1, at 6-16 (1990) (describing the American Savings transaction).

the average cost of funds (deposits, etc.) for thrifts in the Federal Home Loan Bank 11th District, as established periodically by the Federal Home Loan Bank of San Francisco.[2] The interest rate on the note approximated amici's interest obligations to depositors plus its overhead costs on the $8 billion in deposit liabilities which amici assumed and loaned to FSLIC.

Amici accepted this interest rate because FSLIC and FHLBB explicitly agreed in a "Note Forbearance" that, despite then prevailing requirements that thrifts post 3 percent capital to support insurance on deposits, New American would not have to post capital ($240 million) to sustain the $8 billion in deposits which the bank committed to the FSLIC note. The Note Forbearance allowed amici to avoid the cost of this capital (approximately equal to 100 basis points per annum on the $8 billion note). The Note Forbearance also allowed FSLIC to pay a lower interest rate on the note and yet offer a return on investment sufficient to attract amici to the risks of rehabilitating a bankrupt thrift. FSLIC's lowering of amici's required investment by the Note Forbearance lowered the required return.

After review, and as a condition to the closing of the transaction, the general counsel of the FHLBB rendered his written opinion to amici, in customary commercial form, that the transaction, explicitly including the Note Forbearance, "has been duly authorized by all requisite action of the Bank Board and the Corporation," that the agreements "constitute valid and binding obligations of, the Receiver and the Corporation," and that the agreements are "enforceable against the Receiver and the Corporation . . . in accordance with their respective terms."

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[2] The basis point margin started at 225 basis points and decreased over time. *See* note 66 *infra*. The precise margin does not affect the arguments presented here. For simplicity, amici will refer to the rate as 200 basis points above the 11th District average cost of funds.



Thereafter, following the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act, Pub. L. No. 101-73, 103 Stat. 183 (codified at 12 U.S.C. § 1464, *et seq*. (1989)) ("FIRREA"), FSLIC's successor agency advised amici, as it advised the respondents, that it would retain amici's cash investment and the benefits from that investment, retain the valuable warrant amici had provided, retain the proceeds of amici's troubled-asset liquidations, retain amici's investment in the $8 billion FSLIC note, continue to limit its interest payment on the note to the 200 basis point margin, but immediately renounce the Note Forbearance and require amici to post capital for the note -- despite the agreement which had freed amici from that cost -- and pay nothing to compensate amici for the cost of that additional capital.[3]

The government's renunciation of the Note Forbearance agreement hurt amici badly. In practical terms, the renunciation of the Note Forbearance agreement and the imposition on amici of unreimbursed capital costs for the benefit of FSLIC's successor represented an enormous reduction in the net interest margin which FSLIC had agreed to pay on the $8 billion note. Viewed another way, the renunciation of the Note Forbearance and the requirement for additional capital was a unilateral increase in the FSLIC insurance deductible to be borne by amici and a retroactive repricing of the acquisition in favor of FSLIC.[4]

Amici wish to note these matters to illuminate the issues and to alert the Court that the particular forms of respondents'

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[3] OTS, Thrift Bulletin 38-2 (Jan. 9, 1990).

[4] In regard to deposit insurance contracts, "[f]rom the thrift's viewpoint, . . . the deductible is the amount of equity capital at stake." Roger C. Kormendi *et al.*, *The Origins and Resolution of the Thrift Crisis*, 2 J. Applied Corp. Fin. 85, 95 (1989), *reprinted in FHLBB 1988 Deals: Hearing Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 144 (1990) (hereinafter Kormendi).

contracts do not encompass the full universe of contracts presented to the United States Court of Federal Claims.[5]

## SUMMARY OF ARGUMENT

The government characterizes the transactions presented as promises restricting the exercise of "sovereign regulatory powers" and restraining the sovereign from "changing government policy."[6] The government goes on to argue what is essentially a political theory about the government's need at all times to be free to exercise sovereign authority without having "to pay in damages" to exercise that "privilege."[7] The argument is beside the point. This is not a case about limits on the government's sovereign "police power," or the government's entitlement to promote "public health and the public morals."[8] This is not a case, say, where a regulatory agency licensed the sale of a vaccine and then, after Congress barred the vaccine as unsafe, withdrew the license.

In marked contrast, this is a case in which an Insurance Corporation fully engaged in business but insolvent, owned by the government but without the cash to discharge its surety obligations, and seeking to save money for itself, made commercial covenants with respondents much like insurance contracts and bank contracts "between private parties." These contracts "do not implicate sovereign regulatory authority."[9]

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[5] Amici are parties to a complaint filed on December 28, 1992 in the United States Court of Federal Claims, No. 92-872 C.

[6] Gov't Br. at 11.

[7] *Id.*

[8] *Id.* at 11, 37.

[9] Gov't Br. at 20 n.9 (acknowledging that "contract terms that resemble those in contracts between private parties, such as the price term in a lease of land, do not implicate sovereign regulatory authority" (citation omitted)).



Financial covenants regarding capital, net worth maintenance, and leverage, such as those presented to the Court, are commonplace in contracts between private parties, especially in contracts between insurance companies and banks:

> "The most critical of the covenants . . . is the maintenance of solvency, which is frequently stated as an affirmative requirement that the [contract party] maintain a net worth of not less than a stated amount . . . ."[10]

It is routine for private parties to agree on accounting rules departing from Generally Accepted Accounting Principles ("GAAP"), which govern capital and net worth calculations for purposes of financial covenants:

> "The document should also define how net worth is to be calculated. The starting point is generally accepted accounting principles. The main questions from the lender's standpoint are the inclusion or exclusion of *goodwill*, intangible assets, and contingent liabilities."[11]

It is also customary for private parties to express financial contract rights in the negative as "forbearances," which

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[10] Peter H. Weil, *Asset-Based Lending*, ch. 7.2.2.4, "Financial Covenants," at 416-17 (2d ed. 1992) (hereinafter Weil). *See also*, Sandra S. Stern, *Structuring Commercial Loan Agreements*, ¶ 6.03[6] (2d ed. 1990 & 1995 Cumm. Supp. No. 2) (hereinafter Stern) (describing as a common capital covenant in private commercial agreements, promises by a party to maintain at all times: "a ratio of total liabilities to tangible net worth of not greater than ___ to ___" (the "leverage ratio" covenant)).

[11] Weil, *supra* note 10, at 417 (emphasis added). *See also* Stern, *supra* note 10, at ¶ 6.02[6]:

> "GAAP may treat or classify certain items in a way that is not intended by the borrower and the bank. In that case, certain terms must be defined in the loan agreement to ensure that the intended treatment is given to those items."

restrain a party from taking otherwise allowed enforcement actions so long as a covenantor maintains a stipulated level of capital or net worth. Without doubt, "[f]orbearance from exercising a right or doing an act one has a right to do is legal consideration."[12] Forbearance arrangements are especially common in work-out arrangements for the rehabilitation of insolvent companies, such as the thrifts which are the subject of these proceedings.[13]

In essence here, respondents agreed to assume the Insurance Corporation's liabilities to depositors and to risk millions of dollars of new investment in ways that improved the cash position of the Insurance Corporation and saved the Corporation money. In exchange the Corporation contracted to limit capital requirements, to accept an augmented insurance risk (reflected in lower capital requirements), and to insure a substantial quantity of deposits.

The Insurance Corporation made these contracts because they were far less costly to it than other commercial choices, a matter which the Corporation determined explicitly.

Respondents made the contracts because FSLIC offered them the opportunity to reduce their costs of capital, and risks of loss, and to leverage relatively small amounts of costly capital against substantial quantities of cheap (insured) deposits. Leverage had the desirable effect of reducing the aggregate cost of funds to the thrifts and enhancing the prospects that they could lend their funds conservatively but

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[12] *Williston on Contracts* § 7:43 (4th ed. 1992). *See also* Restatement (Second) of Contracts § 71 (1981); Thomas S. Hemmendinger, *Hillman on Commercial Loan Documentation* 473 & 486 Form 24.1, "Forbearance Agreement" § 1 (PLI 4th ed. 1994) (whereby a lender or surety agrees to "forbear in the exercise of its rights and remedies . . . .").

[13] *See* J. Phillip Adams *et al.*, *A Practical Guide to the Tax Considerations and Consequences of Acquiring Stock and Debt Securities of Financially Troubled Corporations, in 7 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings* 674 (PLI 1994).



at a profit commensurate with the risks they were accepting by assuming FSLIC's liabilities.

Thereafter, Congress criticized the Insurance Corporation for accepting the augmented insurance risk, substituted new agencies for the Corporation, and created a new commercial deposit insurance scheme, none of which is challenged here. But Congress also forbad the Corporation from performing certain of its contracts, and overrode certain of the Corporation's capital covenants by boosting capital requirements. These requirements reformulated the allocation of risk of loss between the federal insuring agency and the respondents, and breached the contracts. All in all, Congress, by its deliberate and targeted action, effectively repriced the transactions in favor of the Insurance Corporation, allowed the government to retain the immensely valuable consideration it had received from respondents, and inflicted serious damage upon respondents and others.

No one challenges the sovereign power of the Congress and the President to do what they did in FIRREA and to require the thrift industry to conduct itself according to new rules. Respondents seek only to recover damages caused them by some of those actions, in accordance with customary law applicable both to the government and to private parties which surrounds the making and breaking of financial covenants in commercial insurance contracts.

There is nothing especially governmental about the contracts presented here. As this Court has acknowledged, "the insurance business" is "a conventional commercial endeavor." [14] The government calling FSLIC's promise to leverage respondents' capital a commitment to "restrain regulatory policy" is like calling FSLIC's promise to pay interest on the note a commitment to "restrain financial policy." The use of the word "policy" disguises the commercial character of the matters presented and leads away

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[14] *De La Rama S.S. Co., Inc.* v. *United States*, 344 U.S. 386, 389 (1953).

from a just result. The correct recognition of the contracts as the commercial bargains that they were -- with "terms that resemble those in contracts between private parties",[15] -- obviates the need to plumb the government's political theory, and requires only the recognition that when the government does business and makes business contracts it should obey customary rules of commercial justice.[16]

Certainly FSLIC could have conferred rights on respondents by procedures which would fairly qualify as "regulation." But that is not what happened here. FSLIC covenanted to net worth limits as a business corporation and conveyed leveraging rights through the process of bargain and sale. Respondents bought and paid for those limits and rights with dollars. FSLIC should not now be allowed to take back as "regulation" that which it has just sold for cash.

## ARGUMENT

### I. FSLIC WAS CREATED TO PROVIDE SURETY COMMITMENTS TO THRIFT DEPOSITORS

FSLIC was created in the wake of the bank collapse of the Depression as a wholly-owned government corporation to engage in the insurance business by insuring deposits mainly in federally chartered savings and loan associations. National

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[15] Gov't Br. at 20 n.9.

[16] *See Departments of VA and HUD and Independent Agencies Appropriations for 1993: Hearings Before a Subcomm. of the House Comm. on Appropriations*, 102nd Cong., 2d Sess. pt. 5, at 595-96 (1992) (FY 1993 Explanatory Information, FSLIC Resolution Fund) (explaining the cost-saving by the government "that is generated when the government is perceived as being committed to meeting its contractual obligations." If "the government is perceived as lacking the commitment" then "private industry will be increasingly reluctant to do business with the FDIC or RTC," and "disposing of failed financial institutions . . . will become increasingly difficult," the "incidence of liquidations . . . will rise," the "immediate need for cash with which to pay off insured depositors will increase," "losses will mount," and "the cost to the taxpayers goes up."



Housing Act of 1934, Pub. L. No. 73-479, § 402, 48 Stat. 1246, 1256 (codified as amended at 12 U.S.C. § 1725 (1988)) (repealed 1989). Congress, as the chartering agency, endowed the Insurance Corporation with customary business authority, including the "power . . . [t]o make contracts . . . upon such terms and conditions as the Federal Home Loan Bank Board may determine." *See* 12 U.S.C. § 1725(c)(3), (d).

The purpose of the Insurance Corporation was to provide thrifts with surety commitments which would protect depositors from loss of funds (deposits) loaned to depository institutions,[17] and assure a source of low-cost funds for use in encouraging home ownership.[18]

Throughout its corporate history, the Corporation operated much like a private insurance company and surety: it accepted applications for insurance from eligible institutions, made insurance agreements, 12 U.S.C. § 1726(b) (1988) (repealed 1989), issued certificates of insurance, *id.* § 1726(c), and collected premiums,[19] *id.* § 1727(b). FSLIC controlled insurance risk by supervising lending activities of insured institutions, *id.* § 1726(b), and by requiring that insured institutions co-insure by maintaining capital (shareholders' equity), so that the institutions risked the loss of all of their invested capital before exposing the Corporation to claims on its surety obligations to depositors.[20]

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[17] 12 U.S.C. § 1726(a) (1988) (repealed 1989).

[18] *See* H.R. Rep. No. 1922, 73 Cong., 2nd Sess. 1-2 (1934).

[19] FSLIC insurance premiums were based solely on deposit volume, not the risk of default presented by any particular thrift. *See, e.g., CBO, Reforming Federal Deposit Insurance* 24 (1990); *Condition of the Federal Deposit Insurance Funds: Hearings Before the House Committee on Banking, Finance and Urban Affairs*, 100th Cong., 2d Sess. 188 (1988).

[20] 12 U.S.C. § 1728(a). *See generally* CBO, *Reforming Federal Deposit Insurance* 42-44; CBO, *The Economic Effects of the Savings & Loan Crisis* 3 (1992).

## II. THE CASH CRISIS AT FSLIC

For more than forty years, the Insurance Corporation operated profitably, with premium income and interest earnings substantially in excess of its costs. By 1980, FSLIC had accumulated insurance reserves of some $6.5 billion.[21] But in the 1980's, a variety of problems produced a growing number of thrift insolvencies and failures.[22] Reimbursement of insured depositors at these institutions depleted the Corporation's resources. By the end of 1985, FSLIC's total reserves had slipped to $4.6 billion.[23]

In 1986, continuing large losses required FSLIC to write off the entire secondary reserve. Soon, the Insurance Corporation lost the primary reserve, too.[24] The Comptroller General, as head of the GAO, responsible for auditing FSLIC's financial statements,[25] reported to Congress that FSLIC's financial statements "reflect . . a deficit of more than $6 billion at the end of 1986."[26] FSLIC was clearly insolvent.[27]

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[21] 1987 FHLBB Ann. Rep. 26.

[22] *See generally Oversight on the Condition of the Financial Services Industry: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 2d Sess. 22-24 (1988) (hereinafter *Oversight Hearings*) (statement of GAO).

[23] *Extinguishment of the FSLIC's Secondary Reserve Fund and Its Import Upon the Nation's FSLIC-Insured Institutions: Hearings Before the Subcomm. on General Oversight and Investigations of the House Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 1st Sess. 70 (1987) (hereinafter *Extinguishment Hearings*) (statement of GAO).

[24] *See* GAO, *Financial Audit: FSLIC's 1986 and 1985 Financial Statements* 23.

[25] 31 U.S.C. § 9105 (1988).

[26] GAO, *Financial Audit: FSLIC's 1986 and 1985 Financial Statements* 1.

[27] *See Findings of Booz Allen & Hamilton Study of FHLBB: Hearing Before the Subcomm. on General Oversight & Investigations of the Senate*



Further, the Comptroller "qualified" his audit opinion with respect to FSLIC's 1986 financial statements because of "uncertainty as to whether the Corporation can continue to fulfill its mission and meet its financial obligations."[28]

Shortly thereafter, Edwin Gray, Chairman of the FHLBB, testified that the insurance fund was down to "less than $1 billion in cash and investment securities," and was "being largely forced to shut down its case resolutions;" it was impossible to resolve many of the most costly FSLIC cases because resolution "would require more cash than we have."[29]

Early in 1987, FSLIC "supervisory cases" were losing $3.8 billion per year. Worse, as Chairman Gray testified, "that rate [was] growing dramatically."[30] So were FSLIC's losses. In June 1987, while its insurance obligations remained in the billions of dollars, FSLIC's cash and investments were down to $598 million.[31] By year-end 1987, some 505 savings and loan associations were insolvent and according to the GAO, FSLIC's reserves stood at a negative $13,690,220,000.[32]

FSLIC's grave problems began to feed upon themselves:

1. FSLIC's losses required thrift write-offs of shares of the secondary reserve, which rendered more thrifts insolvent.[33]

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*Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 1st Sess. 38 (1987) (hereinafter *Findings Hearing*) (statement of Edwin J. Gray, Chairman, FHLBB).

[28] GAO, *Financial Audit: FSLIC's 1986 and 1985 Financial Statements* 1.

[29] *Findings Hearing*, *supra* note 27, at 38.

[30] *Id.*; *see also* 1988 FHLBB Ann. Rep. 22.

[31] *Extinguishment Hearings*, *supra* note 23, at 72 (statement of GAO).

[32] *Id.* at 49.

[33] *See Extinguishment Hearings*, *supra* note 23, at 42, 47 (statement of the U.S. League of Savings Institutions).

2. FSLIC was illiquid from losses and from its inability to sell off thrift assets to recoup payments to depositors.[34] Thrift assets comprised mostly mortgage loans receivable, many delinquent, and real estate owned by the thrifts, mostly as a result of foreclosures. FSLIC could not dump these assets without breaking markets, sacrificing the value of the assets, undermining the value of collateral supporting still operating thrift institutions, thrusting more thrifts into insolvency, and imposing further burdens on itself.

3. In 1987, the American Institute of Certified Public Accountants, responding to FSLIC's severe insolvency, directed auditors for companies which accepted FSLIC notes to acknowledge the prospect of a FSLIC default with references in the financial statements and disclosures among "risk factors."[35] These accounting requirements made FSLIC notes less valuable and acceptable. Chairman Gray testified that FSLIC's "insolvency may cause accountants to require additional millions of dollars of write-downs by thrifts holding FSLIC notes," which would accelerate the collapse of additional thrifts.[36] At the same time, the GAO criticized FSLIC's assumption that investors would be willing to accept FSLIC notes rather than cash: "In view of FSLIC's precarious financial condition, we believe the degree to which FSLIC notes will be accepted as substitutes for cash remains

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[34] *See FHLBB 1988 Deals: Hearing Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 186 (1990) (hereinafter *1988 Deals Hearing*) (statement of Lawrence J. White, Professor, New York University).

[35] AICPA, *Prepayments Into the Secondary Reserve of the FSLIC and Contingencies Related to Other Obligations of FSLIC*, Practice Bulletin 3, at 7 (1987) ("Although FSLIC at present continues to meet its financial obligations under those agreements, the uncertainties about its financial condition lead to a conclusion that a loss [on the notes] is at least reasonably possible.").

[36] *Findings Hearing*, *supra* note 27, at 38 (statement of Edwin J. Gray).



an open question."[37] Indeed, FSLIC's credit was so bad that the Federal Home Loan Banks refused to lend funds where thrifts offered a FSLIC instrument as collateral.[38]

4. FSLIC's lack of resources with which to resolve "but the smallest trickle" of the insolvent thrifts "due to its insolvency"[39] radically raised FSLIC's costs and losses.[40] Assets of insolvent but operating thrifts lost value at an accelerated pace.[41] Failing thrifts bid up interest rates on deposits, pushing competing thrifts into insolvency.[42] This required FSLIC both to resolve more thrifts and to issue notes at high interest rates to compensate acquirors for assuming high cost liabilities to depositors (i.e., high interest rate deposits).[43] It was imperative that FSLIC resolve failed thrifts quickly. But that required cash, and FSLIC had no cash.[44]

The next year brought no surcease. As the GAO reported, FSLIC started 1988 with responsibility for more than 200 "hopelessly insolvent institutions"[45] presenting an estimated

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[37] *Oversight Hearings*, *supra* note 22, at 26 (statement GAO).

[38] *Financial Condition of Federally Insured Depository Institutions: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 84 (1987) (hereinafter *Financial Hearing*) (statement of Edwin J. Gray).

[39] *Id.*

[40] 1987 FHLBB Ann. Rep. 27; *Oversight Hearings*, *supra* note 22, at 24, 27.

[41] *Financial Hearing*, *supra* note 38, at 84.

[42] See e.g., *Oversight Hearings*, *supra* note 22, at 27 (statement of GAO); *Findings Hearing*, *supra* note 27, at 38 (statement of Edwin J. Gray).

[43] RTC, *supra* note 1, Vol. 1, at 31.

[44] *Id.*; *see also* CBO, *Reforming Federal Deposit Insurance* at xiv (1990).

[45] 1987 FHLBB Ann. Rep. 27; *see also Oversight Hearings*, *supra* note

cost of $17.4 billion. And there were perhaps 300 additional institutions that would require resolution.[46] The Corporation estimated its 1988 costs at $33 billion.[47] But M. Danny Wall, then Chairman of the Bank Board, testified that "a precise estimate of the potential costs of resolving the problems of troubled FSLIC-insured institutions is not possible."[48] Wall noted that the Comptroller had criticized FSLIC's estimates as probably too optimistic. [49]

The Comptroller was right. Despite repeated efforts to recapitalize itself, in 1988 FSLIC reported a loss of $66 billion. On December 31, 1988 the Insurance Corporation had a net worth of *negative* $74,991,090,000.[50]

Finally, in 1989, Congress put the Corporation out of its misery. The Congressional Budget Office summed up these events as the "bankruptcy of FSLIC."[51] William Seidman, Chairman of both the FDIC and the RTC, testified about FSLIC's efforts: "[I]t was evident that the Bank Board was attempting to negotiate with no cash and doubtful credit."[52]

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22, at 24 (statement of GAO).

[46] 1987 FHLBB Ann. Rep. 9, 27; *see also* 1988 FHLBB Ann. Rep. 21.

[47] 1988 FHLBB Ann. Rep. 21.

[48] *Condition of the Federal Deposit Insurance Funds: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 2d Sess. 185 (1988).

[49] 1988 FHLBB Ann. Rep. 21-22.

[50] *Id.* at 25, 49.

[51] CBO, *Reforming Federal Deposit Insurance* at xiv (1990).

[52] *1988 Deals Hearing*, *supra* note 34, at 20.



## III. FSLIC FORBEARANCES WERE NET WORTH COVENANTS COMMON IN CONTRACTS "BETWEEN PRIVATE PARTIES"

Short of cash, FSLIC solicited investors who would acquire insolvent thrifts and obviate the need for the Corporation to make massive payments to depositors. These investors invested cash and other forms of new value. FSLIC determined each thrift disposition to investors to be less costly to FSLIC than liquidation, by more than $7.2 billion in total.[53] Plainly, FSLIC made the contracts that it did in order to save money.[54]

The thrifts FSLIC offered for acquisition shared two fundamental characteristics: they were book insolvent, (*i.e.*, the book value of their liabilities exceeded the book value of their assets) and the book value of their assets exceeded true value. FSLIC asked investors to assume liabilities to depositors vastly in excess of thrift assets. No rational business person would do that without more.

To encourage thrift acquisitions, FSLIC offered investors forms of "assistance" expressed in "assistance agreements." Assistance was overwhelmingly non-cash, and included commitments of deposit insurance which cut the cost and amount of required investor capital. FSLIC had no cash, but insurance was FSLIC's stock in trade.[55]

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[53] *See 1988 Deals Hearing*, *supra* note 34, at 195 (statement of Lawrence J. White, Professor, New York University); Kormendi, *supra* note 4, at 93.

[54] For example, between 1985 and 1987, FSLIC's merger costs were 16 percent of the merged institutions' assets, while liquidation costs were 49 percent of the institutions' assets. *Oversight Hearings*, *supra* note 22, at 25.

[55] Alan Greenspan, Chairman of the Federal Reserve Board, testified to Congress that FSLIC assisted thrifts by accepting enhanced insurance risks. *Deposit Insurance Issues and Depositor Discipline: Hearing Before the Commerce, Consumer and Monetary Affairs Subcomm. of the House*

The main types of assistance comprised the following:[56]

1. *Negative net worth notes* represented the excess *book value* of liabilities assumed over assets acquired, and bore interest at contracted amounts.[57]

2. *Yield maintenance payments* indemnified acquirors for the difference between actual yield achieved on certain assets (*e.g.*, notes in default) and an agreed rate.[58]

3. *Capital loss coverage* indemnified acquirors for losses incurred upon sale of assets at less than book value or write-down of assets by the "mark-to-market" process.[59]

4. *Tax benefits sharing* authorized use of pre-acquisition thrift losses to shelter post-acquisition earnings.[60]

5. *Capital forbearances* were net worth covenants that reduced required tangible capital commitments to levels below those FSLIC then generally required. These forbearances cut the *cost* of capital for acquirors, reduced the overall investment returns FSLIC had to offer, and presented opportunities to leverage relatively small amounts of high-cost capital against large amounts of low-cost (insured) deposits,

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*Comm. on Government Operations*, 101st Cong., 2d Sess. 17-19 (1990).

[56] *See generally* RTC, *supra* note 1, Vol. 1, at 46-47.

[57] *1988 Deals Hearing*, *supra* note 34, at 10 (statement of GAO).

[58] *Id.* For example, if the specified yield maintenance rate for an asset was 10 percent of book value per annum and the asset produced 4 percent (rents, interest, etc.), then FSLIC was contractually committed to pay the acquiror an additional 6 percent -- bringing the total yield to 10 percent.

[59] *Id.* The negative net worth notes were based on *book* values. Capital loss coverage was based on actual sales prices or fair *market* values.

[60] *See* I.R.C. § 382(1)(5)(F) (1988) (repealed in 1989 for acquisitions occurring on or after May 10, 1989). Generally, FSLIC required acquirors to pay over to FSLIC some portion of the taxes they saved as a result of the tax benefits. Thus, FSLIC used the acquirors to monetize unusable (by FSLIC) losses and to divert what otherwise would have been taxes paid to the IRS into a cash stream for FSLIC.



thereby reducing the aggregate cost of funds to the acquired thrifts and raising prospects for profitability.[61]

All forms of assistance are equivalent to *price* terms. All have a dollar equivalency. All were designed to offer profit opportunities to acquirors who would assume FSLIC's liabilities, invest cash, risk FSLIC's credit, save FSLIC huge sums of money, and protect FSLIC from *commercial* failure. All deserve equal commercial dignity as binding contracts.

The government acknowledges, as it must, that Congress and the President could not avoid contract obligations by legislation which reduced FSLIC yield maintenance, eliminated capital loss protection, cut interest rates on FSLIC notes, or changed other "terms that resemble those in contracts between private parties, such as the price term," without engendering liability to thrift contract parties.[62] But that is precisely what the government argues for here. The capital agreements were not licenses to sell dangerous drugs or to run high speed trains through grade crossings, which only a government could provide. As all the other forms of assistance, the forbearances were strictly commercial: net worth covenants made by an insurance company with a bank,

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[61] *See* FHLBB, Net Worth Requirements of Insured Institutions, 50 Fed. Reg. 6891 (1985) (announcing amendment to capital requirements, noting that imposition of a 3 percent capital requirement has the effect of *"limiting ability to leverage new liabilities to a ratio of 33 to 1"* (emphasis added)). According to the FHLBB:

> "When an institution engages in an acquisition . . . in a supervisory context, [FSLIC] may act to reduce the impact which such a transaction could have under the net-worth regulation on the acquiring institution's minimum net-worth requirement. In this respect, the Board wishes to emphasize that it will continue its long-standing policy of encouraging the Corporation *to negotiate appropriately tailored forbearance agreements with institutions that are prepared to enter into supervisory acquisitions . . . at the Corporation's request.*"

*Id.* at 6898 (emphasis added).

[62] Gov't Br. at 20 n.9.

for which the acquirors paid FSLIC in full -- the kind of covenants which are commonplace in transactions "between private parties." It would "offend . . . standards of fairness" to deny remedies to respondents here in this "conventional commercial endeavor."[63]

## IV. THE CAPITAL AGREEMENTS REPRESENTED SIGNIFICANT ECONOMIC SUBSTANCE

Amici's contract highlights the *commercial* character of respondents' transactions described *infra* at Part V.

Old American was the largest insolvent thrift in the country. It had more than $30 billion in liabilities and a huge net worth deficit. In late 1988, FSLIC put the thrift into receivership but lacked the cash needed to close the thrift and pay off the depositors or to pay required assistance to an acquiror. Amici were the only investors FSLIC believed were able to rehabilitate Old American.[64]

Pursuant to the acquisition contract, amici agreed to extend $8 billion of credit to FSLIC by assuming $8 billion of liabilities for which there were no offsetting assets in New American, and by accepting an $8 billion FSLIC note to fill the enormous hole in the New American balance sheet.[65]

FSLIC contracted to pay an interest rate on the note which was some 200 basis points over the average cost of funds to thrifts, reflected in an index prepared by the San Francisco Federal Home Loan Bank.[66] Amici's interest cost on the deposit liabilities it assumed was higher than this average cost because Old American, to stem near-fatal runs, had boosted

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[63] *De La Rama S.S. Co., Inc.* v. *United States*, 344 U.S. 386, 389 (1953).

[64] *See* RTC, *supra* note 1, Vol. 6, Tab 1, at 1, 2-3, 4, 6.

[65] *Id.* at 11. The note was initially $7.8 billion and then adjusted after audit to approximately $8 billion.

[66] To be precise, the note bears an adjustable interest rate: initially 225 basis points over the index for a period, then 200 basis points for a period, and then 175 basis points until maturity in 1998. *Id.*, Vol. 1, at 105.



interest rates to retain deposits.[67] Thus, the interest rate FSLIC agreed to pay amici on the note roughly equalled New American's interest and overhead costs in servicing depositors on the $8 billion of liabilities which New American assumed and loaned to FSLIC.

Amici accepted this pass-through interest rate because FSLIC agreed that for the ten-year life of the note it would forebear from requiring amici to post capital to support the note.[68] This Note Forbearance Agreement relieved amici of the obligation to post some $240,000,000 of capital (3% x $8 billion).[69]

The Note Forbearance represented both a saving in cost and reduction in risk to amici. The industry disaster had driven up the cost of thrift capital. Sophisticated investors, cautioned by their accountants and eyeing FSLIC's impaired credit, sought annual returns of 25 to 40 percent on capital risked in efforts to revive bankrupt thrifts.[70] And no one had ever revived a thrift as large as Old American.[71]

If we accept an annual cost of capital of 35 percent (for the sake of argument), then, but for FSLIC's Note Forbearance, amici would have had to invest an additional $240,000,000 at an additional annual cost of $84 million (35% x $240 million = $84 million). That cost approximates one-half of the margin FSLIC agreed to pay on the $8 billion note (100 basis points (1%) x $8 billion = $80 million).

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[67] *Id.*, Vol. 6, Tab 1, at 45.

[68] *Id.* at 21-22.

[69] The $240,000,000 is approximate. The precise amount does not affect the argument presented. The $240,000,000 would have been additional to the $350 million cash which amici invested in New American.

[70] The Court of Federal Claims has yet to determine the precise cost of capital. But the argument presented is meritorious at whatever the cost of capital ultimately determined, because it is a cost FSLIC would have had to bear but for its agreement to the Note Forbearance.

[71] RTC, *supra* note 1, Vol. 6, Tab 1, at 4.

Thus, but for the Note Forbearance, in order to reimburse amici's costs in assuming the $8 billion in deposit liabilities, *FSLIC* would have had to pay amici that additional $84 million per year in *cash*. This obligation would have been expressed by an interest rate in the note substantially *greater* than the stated 200 basis points margin. The 200 basis points margin was linked to the Note Forbearance.

Without doubt, FSLIC's agreement to forbear from requiring amici to post capital saved amici the cost of that capital. That was the point of the Note Forbearance. But important here is that FSLIC's agreement saved *FSLIC* the cost of providing a return to amici on that additional capital. Thus, FSLIC agreed to forbear from requiring $240,000,000 capital under then-applicable rules in order to save *itself* the cost of that capital. By reducing amici's required contribution of capital, FSLIC knowingly traded enhanced insurance risk-taking for cost-saving.[72] It was strictly commerce -- not "sovereignty" or "regulation."

Then, the government renounced the Note Forbearance and imposed the cost of additional capital on amici *solely for the benefit of FSLIC's successor*, with no increase in interest on the note to compensate amici for their additional cost.[73] The renunciation of the terms on which the interest margin was agreed for the sole benefit of the maker of the note is the precise equivalent of the government dropping the stated interest rate on the FSLIC note -- or changing the promised medium of repayment to greenbacks from gold. *See Perry* v. *United States*, 294 U.S. 330 (1935).

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[72] The trade was responsible. Capital protects the deposit insurer against a thrift's losses from the investment of insured deposits in bad loans. But here amici invested the deposits in a loan *to FSLIC*. Moreover, if the Note Forbearance aided New American's profitability, FSLIC would participate through its 30 percent warrant in New American.

[73] Nothing in FIRREA required that renunciation because the Note Forbearance did not involve goodwill.



## V. "GOODWILL" AND "CAPITAL CREDITS" WERE ONLY ACCOUNTING TERMS FSLIC CHOSE TO EXPRESS ITS COMMERCIAL AGREEMENTS

The transactions before the Court also demonstrate savings *by FSLIC* in the assistance payable to respondents as a result of FSLIC agreeing to accept diminished amounts of capital investment.[74] FSLIC agreed to reduce respondents' capital costs in lieu of paying respondents cash. The principles of commerce which prevail in contracts between private parties support recovery for the government's renunciation of those net worth covenants.

In the years under consideration, FSLIC generally required thrifts to maintain 3 percent capital. Among thrifts, capital is a proxy for deposits. Any particular level of capital, whether cash, "goodwill," or a "capital credit," translates under the terms of the insurance regime into a determinable level of allowed insured deposits. FSLIC and thrifts commonly referred to this relationship of capital and insured deposits as the "leverage ratio" or the "leverage limit." A 3 percent capital requirement or a 3 percent leverage limit thus authorized thrifts to hold $100 of FSLIC-insured deposits for every $3 of capital.[75]

Tangible capital was subject to all the entrepreneurial perils of the thrift business, and was very costly. But deposits were cheap. Because the government guaranteed the creditworthiness of thrifts, depositors did not fear a thrift's default, did not demand a default risk premium, and were willing to lend deposits to thrifts at low annual interest rates.[76] The low costs for deposits were important. Thrifts could not pay 35 percent returns for capital and profitably lend

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[74] Capital (or net worth or owners' equity) is the difference between assets and liabilities. *See* 1988 FHLBB Ann. Rep. 24 n.1.

[75] *See, e.g., supra* note 61. Again, the precise level of required capital does not affect the argument presented.

[76] *See* Kormendi, *supra* note 4, at 87.

that money on home mortgages at 8 percent. They needed a large quantity of cheap deposits per dollar of expensive capital to lower the *aggregate* cost of funds and increase the profit margins on loans to their borrowers.

FSLIC knew this leverage between capital and deposits was vitally important to the thrift acquirors it solicited.[77] Reducing capital requirements per unit of deposits raises returns on equity.[78] That is why FSLIC featured the availability of agreements reducing the need for capital in its standard package of bid solicitation materials.[79] It was the common agreement among FSLIC and acquirors about the commercial value of leverage as between capital and deposits which underlay the use of the accounting terms "regulatory goodwill" and "capital credits" in FSLIC's resolution contracts.

To induce respondents to assume billions of dollars of liabilities for which FSLIC bore responsibility as insurer, FSLIC offered to increase the leverage limit by reducing capital requirements below the customary 3 percent. By this consideration, FSLIC offered what was, in practical terms, the opportunity to obtain $100 of insured deposits for an investment of costly capital of *less* than $3.

The increase in the leverage limit increased FSLIC's risk as an insurer.[80] That was the acknowledged consequence of

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[77] The Bank Board acknowledged that FSLIC sought to "leverage private sector participation" in resolving the thrift crisis. *Oversight Hearing*, *supra* note 22, at 353 (statement of M. Danny Wall).

[78] *Cf.* CBO, *Reforming Federal Deposit Insurance* 59, 75 (1990) ("[A] trade-off exists between increasing capital requirements and maintaining the profitability and viability of depositories.").

[79] *See, e.g.*, FHLBB, Memorandum SP-37a to Principal Supervisory Agents, "Requests for Forbearances and Exceptions to Filing Requirements Regarding Supervisory Institutions" (March 7, 1986); 50 Fed. Reg. at 6898, *supra* note 61.

[80] *Cf.* CBO, *Reforming Federal Deposit Insurance* 58 (1990) ("Capital serves the deposit insurer . . .[b]y provid[ing] a buffer for the uncertainty



diminished capital in insured thrifts.[81] FSLIC offered leverage and accepted risk because it lacked cash. Thus, FSLIC contracted to provide deposit insurance, to reduce capital requirements, and to accept augmented insurance risk as a means of luring new investment into failed thrifts. This new investment took the form of fresh cash (*e.g.*, Winstar and Statesman) or the acquiring company's pre-existing net worth (*e.g.*, Glendale).

FSLIC and thrift acquirors could have expressed their bargains regarding leverage simply by saying that the thrifts could hold $100 of insured deposits for every *$2* of tangible capital, (*i.e.*, a 2% capital requirement). Or FSLIC could have said to thrift acquirors that it would insure deposits in an amount equal to fifty times the acquirors' tangible invested capital (*i.e.*, a 2% capital rule).[82]

Instead, FSLIC and the acquirors expressed their bargains as departures from FSLIC's otherwise prevailing limitation of $100 of insured deposits per $3 dollars of tangible capital.

To account for these leverage agreements, FSLIC and the acquirors used various *constructed* book entries such as "regulatory goodwill" and "capital credits." But these were only balance sheet notations. Their practical value lay in their

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in determining the economic solvency of an institution.").

[81] The financial institution's own capital or equity is "the first line of defense" for the deposit insurance fund in case the financial institution's investments go bad. CBO, *The Economic Effects of the S&L Crisis* 3 (1992).

[82] In 1990, in testimony to Congress on the Federal Home Loan Bank Board 1988 Deals, the GAO noted that "[i]n return for about $2.2 billion of contributed capital, in the 94 assistance cases [investors] received $104.4 billion in assets; or about $46 in assets for every $1 invested." *Hearing Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 9 (1990). That ratio of capital to assets (1:46) is only slightly greater than 2 percent (2.107%).

utility to express FSLIC's agreement to augmented leverage in exchange for the new investment.[83]

The following simplified thrift balance sheets demonstrate these propositions:

THRIFT BALANCE SHEET A

| Assets | | Liabilities and Owners' Equity |
|---|---|---|
| Cash Borrowed from Insured Depositors | $100 | $100 Owed to Insured Depositors |
| | | $100 TOTAL LIABILITIES |
| Cash from Investors | $ 2 | $ 2 Owners' Equity ("Tangible Capital") |
| TOTAL ASSETS | $102 | $102 TOTAL LIABILITIES & EQUITY |

Balance Sheet A reflects compliance with a 2 percent capital agreement.

Alternatively, the parties could have accounted for the same agreement by using a "regulatory goodwill" entry:

THRIFT BALANCE SHEET B

| Assets | | Liabilities and Owners' Equity |
|---|---|---|
| Cash Borrowed from Insured Depositors | $100 | $100 Owed to Insured Depositors |
| | | $100 TOTAL LIABILITIES |
| Cash from Investors | $ 2 | $ 2 Owners' Equity ("Tangible Capital") |
| Regulatory Goodwill | $ 1 | $ 1 Owners' Equity ("Intangible Capital") |
| | | $ 3 TOTAL OWNERS' EQUITY |
| TOTAL ASSETS | $103 | $103 TOTAL LIABILITIES & EQUITY |

Balance Sheet B expresses the same *2* percent capital agreement with FSLIC as does Balance Sheet A. But it does so in special "regulatory accounting" terms which present the thrift's financial picture as compliance with a *3* percent capital

[83] From all that appears, "regulatory goodwill" and "capital credits" were terms FSLIC created merely to make the books of leveraged thrifts conform in appearance to all others and permit FSLIC to use its benchmarks for auditing thrifts without separate notation.



rule. In Balance Sheet B, "regulatory goodwill" is a constructed asset of no tangible value. The "regulatory goodwill" entry simply expresses the agreed leverage arrangements in accounting terms tailored by FSLIC to the thrift industry.

The situation is the same with "capital credits:"

THRIFT BALANCE SHEET C

| Assets | | Liabilities and Owners' Equity |
|---|---|---|
| Cash Borrowed from Insured Depositors | $100 | $100 Owed to Insured Depositors |
| | | $100 TOTAL LIABILITIES |
| Cash from Investors | $ 2 | $ 2 Owners' Equity ("Tangible Capital") |
| Capital Credit | $ 1 | $ 1 Owners' Equity ("Intangible Capital") |
| | | $ 3 TOTAL OWNERS' EQUITY |
| TOTAL ASSETS | $103 | $103 TOTAL LIABILITIES & EQUITY |

Here again, the "capital credit" is merely a constructed term put on the balance sheet only to reflect in familiar accounting language the leverage arrangements explicitly agreed to by acquirors and FSLIC.

The form of accounting the parties chose to express their agreements should not reasonably affect the enforceability of the agreements. All of the examples reflect the same deliberate exchange of new value for insurance risk wherein FSLIC agreed to insure $100 of deposits for every $2 in tangible investment. This is not sovereignty, just commerce.

## VI. REQUIRED CAPITAL WAS THE "DEDUCTIBLE" IN FSLIC'S INSURANCE ARRANGEMENTS

To reduce these matters even further to the realm of common experience, one can properly say that FSLIC agreed to insurance contracts covering $100 of deposits with the investors committing to a $2 co-insurance payment in the

nature of a *deductible*.[84] The deductible took the form of capital.[85] The investors co-insured the deposits by placing their $2 of tangible capital at risk in front of FSLIC's $100 of insurance obligation. FSLIC was required to pay nothing to depositors until the thrift paid out all of its assets including the investors' $2.

FSLIC was well within its statutory authority to accept the additional risk which accompanied this diminished coinsurance ($2 vs. the customary $3 deductible).[86] Congress in FIRREA objected to FSLIC's acceptance of that risk and now requires the FDIC as FSLIC's successor to write insurance contracts which require thrift owners to pay no less than a $3 deductible (or a $5 deductible, etc.). But the unilateral change in the deductible of previously negotiated contracts is a breach that entitles the respondents, who performed those contracts, to recover in damages.

## VII. THERE IS NOTHING PARTICULARLY SOVEREIGN OR GOVERNMENTAL ABOUT DEPOSIT INSURANCE

The government bases all of its arguments on political theory about the inalienability of various police powers, and makes a considerable effort to ignore the commercial character of the Insurance Corporation and the contracts presented to the Court. But there is nothing particularly sovereign or governmental about deposit insurance. It is "a conventional commercial endeavor."[87] Private deposit insurance existed

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[84] Co-insurance places a portion of the risk on the insured, thereby reducing the insurer's risk burden. It is usually achieved by a deductible. *See* CBO, *Reforming Federal Deposit Insurance* 44.

[85] *See supra* note 4.

[86] *See e.g.*, Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, § 105, 92 Stat. 3641, 3647 (1978) (amending Section 406(f) of the National Housing Act).

[87] *See De La Rama*, 344 U.S. at 389.



in this country before FSLIC was created.[88] Private deposit insurance continues to exist.[89] And many debate an expanded role in the economy for private deposit insurance.[90] It is therefore misleading for the government to speak of "sovereign regulatory authority" when all that is called for is conventional commercial justice.

True enough, the Insurance Corporation was wholly owned by the government. But that cannot transmute its insurance transactions from conventional commerce into "sovereign acts" of "regulatory policy." The TVA, the Saint Lawrence Seaway Development Corporation, the OPIC, the GNMA, the Export-Import Bank, the Uranium Enrichment Corporation, and other huge commercial enterprises, are also wholly owned by the government.[91] These corporations engage in business on a vast scale. That they are owned by the nation cannot

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[88] New York banks established the first deposit insurance system in 1829 to guarantee bank notes and deposits. *See* CBO, *Reforming Federal Deposit Insurance* 7-8. *See also* FDIC *et al.*, *Report to Congress on Federal Deposit Insurance*, 98th Cong., 1st Sess. 139 (Joint Comm. Print 1983).

[89] *See, e.g.*, Evelyn Gilbert, *Excess FDIC Deposit Insurance Coverage Is Now Available*, Nat'l Underwriter Prop. & Casualty-Risk & Ben. Mgmt. 27, March 22, 1993; FDIC *et al.*, *supra* note 88, at 140 ("Private sector deposit insurance coverage is offered by some casualty and surety companies on a limited basis. This coverage generally takes the form of a surety bond, essentially providing clients with a guarantee that their deposit in a specific institution will be recovered at a specific time.").

[90] *See, e.g.*, FDIC *et al.*, *supra* note 88, at 30 ("To the extent that the private sector is capable of offering additional insurance coverage, this would add to the strength of market forces policing banking and the FDIC would of course welcome such a development."); *Deposit Insurance Issues and Deposit Discipline: Hearing Before the Commerce, Consumer, and Monetary Affairs Subcomm. of the House Comm. on Government Operations*, 101st Cong., 2d Sess. 25-26 (1990) (statement of Alan Greenspan) ("Another option [is] to rely more on . . . private deposit insurance as a replacement for FDIC insurance.").

[91] *See* 31 U.S.C. § 9101 (1988) (defining "wholly owned Government corporation" and listing FSLIC among the other government businesses).

reasonably mean that they are singularly disabled from making long-term commitments or that they are uniquely enabled to avoid long-term commitments with no obligation to the contract parties they injure. They must remain subject to customary rules of commerce and "standards of fairness . . . for private enterprise."[92] Any contrary rule would reduce these great businesses to barter transactions and so significantly raise their costs of doing business as to frustrate the public benefits their creation was intended to achieve.[93]

## CONCLUSION

For the reasons stated, amici respectfully urge the Court to affirm the decision of the United States Court of Appeals for the Federal Circuit.

Respectfully submitted,

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[92] *See De La Rama*, 344 U.S. at 389.

[93] The same legislation which created FSLIC also created the Federal Housing Administration and FHA insurance of home mortgage loans. National Housing Act of 1934, Pub. L. No. 73-479, §§ 1, 2, 202, and 402, 48 Stat. 1246, 1248, 1256. There is, of course, private mortgage insurance to complement FHA insurance. Huge markets for pools of FHA-insured mortgages would be devastated if the government could freely and retroactively change the terms on which FHA insured these mortgages.